

THE FARR VIEW

A QUARTERLY NEWSLETTER FROM FARR, MILLER & WASHINGTON



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Michael Farr is a regular Contributor on CNBC. He frequently appears on CBS Radio, NPR, Associated Press Radio, and



The Nightly Business Report. He is quoted in The Wall Street Journal,

USA Today, Forbes, The Washington Post, and many others.



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To learn about the services that we provide, please contact us:

Farr, Miller & Washington
1020 19th Street, NW, Suite 200
Washington, DC 20036
(202) 530-5600
(800) 390-3277 toll-free
(202) 530-5508 fax
invest@farmiller.com
www.farmiller.com

More to Fear Than Fear Itself?

In the third-quarter edition of *The Farr View*, as in many editions prior, we focused a lot of attention on the many different challenges that investors would face as this economic cycle grows long-in-the-tooth. We said that fleeting tax-cut benefits, rising interest rates, high debt levels, and slowing growth outside the US were among the factors that would cause a deceleration in economic growth from the strong levels in the second and third quarters. We also speculated that the Fed may be committing a policy mistake by hiking interest rates too far and too fast. Our long-held opinion was then, and remains, that the economy cannot withstand significantly higher interest rates.

Well, there is a bit more of the same in our message this time. High debt levels and ill-timed fiscal stimulus continue to leave us vulnerable in the event of a significant economic slowdown. The U.S. is also not making the long-term investments necessary to drive labor productivity, boost middle-class incomes, and reduce economic inequality. These chronic issues will keep our economic optimism grounded well into the future.

That said, we are also seeing some hopeful signs for equity investors following the 20% peak-to-trough correction we endured during the fourth quarter. Whereas we continue to see plenty of policy risk, we are

also becoming more sanguine about the possibility of successfully resolving some of those issues. We are most encouraged by the latest signaling from the Fed, which suggests a pause in policy normalization, and progress on trade talks with China.

Our overriding message, then, is that the trends we experienced in the fourth quarter, including the correction in stock prices, a moderation in earnings expectations, and a reduction in investor complacency, have created opportunities that have been elusive for much of the past several years. These opportunities should be a welcome development for long-term investors.

Economic Growth is Indeed Slowing

There have been numerous indicators that suggest global economic growth is slowing, and materially so. The evidence outside the US has been ongoing since the beginning of 2018. Europe, the UK, China and other emerging economies are all slowing to varying degrees. In the US, the contagion has been pushed out by the tax cuts and spending bill, which actually caused economic activity to accelerate through most of 2018. The glaring exception was the housing market, which slowed most of the year as reduced affordability and low inventories affected sales activity and price increases.

Continued

More recently, we've received evidence that growth in business investment and manufacturing have slowed materially, albeit from very healthy levels. Higher interest rates, a strong dollar, plummeting oil prices, and the trade standoff finally appear to be taking a toll on a broader swath of the economy. Importantly, though, consumer spending, which represents two-thirds of the US economy, remains fairly robust. Whether or not this continues will be of paramount importance.

The markets have provided additional evidence that all is not rosy with the domestic economy. We've seen stock prices crater, long-term interest rates fall, the yield curve flatten, credit spreads widen and commodities like oil and copper tumble. Inflation and inflation expectations, as measured by a variety of metrics and market indicators, appear to be falling after steady increases in previous quarters. These data points add to a body of evidence that suggests global growth has already peaked and may continue to slow in 2019 and perhaps beyond.

Policy Risks

In its actions to date, the Fed has not heeded the markets' warnings. Emboldened by continued strong labor-market data, the Fed raised short-term interest rates for a fourth time in December, with its formal statement suggesting more hikes to come in 2019. The standard Fed refrain is that the economy remains quite strong, and low unemployment will eventually cause inflationary pressures. But a more discerning eye is seeing that the tide is beginning to turn. Individual Fed members are beginning to hedge their statements.

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The inescapable fact is that eight years of nearly free money has caused debt to balloon, asset prices to soar, inequality to expand, and demand to be pulled forward. Quite predictably, then, the unwinding of said policy is causing economic uncertainty and market volatility.

In its steady path toward tightening, we think the Fed has been slow to acknowledge a couple important facts. First, inflation is a global phenomenon, and China's rise to an economic powerhouse and the current economic weakness outside the US are both disinflationary forces. Therefore, the Fed needs to consider the ongoing disinflationary influences coming from outside the US as well as the significant evidence of disinflation within the US. Second, the sheer amount of debt that has accumulated in the US makes *deflation* - not *inflation* - the bigger risk to the economy. Higher inflation makes our massive debt load more manageable (as debt can be repaid in devalued dollars), and so the Fed should be erring on the side of overstimulating rather than the opposite. Perhaps an easier way to think about it is this: Why is the Fed reducing its portfolio of Treasury (and mortgage) bonds and raising interest rates just as the Treasury Department's funding needs are set to increase dramatically? Does that sound like sound policy?

There are other "policy risks" that have contributed to the souring in investor

sentiment we saw in the fourth quarter. The large fiscal stimulus that boosted economic growth and corporate profits in 2018 is set to be a drag on the economy and profit growth in 2019. The imposition of tariffs on our trading partners has created uncertainty, reduced manufacturing activity and suppressed corporate investment. Our immigration squabbles have led to an ongoing government shutdown, which may have a small but measurable impact on the economy, and some of the proposed immigration policies have the potential to create labor shortages over time. And the administration's energy policies have contributed to a sharp drop in oil prices, weighing heavily on the domestic energy industry and creating a dour outlook regarding climate change. Without minimizing the importance of these issues, though, one thing remains clear to us: **The tight-rope act of normalizing monetary policy following nine years of monetary excess continues to represent the single-most important factor from an investment perspective.**

The Pause That Refreshes

Notwithstanding the intensifying economic and policy risks, stock valuations are far less demanding now that prices have pulled back significantly and earnings have continued to grow. Let's talk about earnings first.

Fueled in part by the Tax Cuts and Jobs Act of 2017, earnings for the companies in the S&P 500 are expected to have grown about 22% in 2018 following 12% growth in 2017. For 2019, analysts currently expect S&P 500 earnings to grow about 7%. Could earnings estimates for 2019 and beyond be too optimistic? Absolutely. A slowing global economy coupled with unusually high levels of policy risk may indeed cause earnings estimates to come down somewhat more than they already have. But the price adjustments we've suffered to date have created opportunities for long-term investors. And it's important to remember that lower valuations not only increase future returns but they also reduce some of the downside risk.

As of this writing, the S&P 500 was down about 12% from its all-time high after being down as much as 20%. At current levels, the S&P 500 is trading at just 15.0x the consensus estimate for 2019 earnings—below the average of 15.7x since the year 2000. It is worth pointing out that many individual stocks and industry sectors are down much more than the 12% decline in the S&P 500. In fact, well over half of the stocks in the S&P 500 remain down more than 20% from their 52-week highs even after the recent market bounce! The famed FAANG stocks, which consist of five technology bellwethers that had led the overall markets relentlessly higher for several years, are down about 25% on average from their highs. The drop in the FAANG stocks makes the overall market far less dependent on those behemoths. The same goes for the economically sensitive Energy and Industrials sectors, both of which are down well in excess of the overall market.

We've also seen a dramatic pullback in

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long-term interest rates, even as the Fed continues to raise the short-term Fed Funds rate. The yield on the 10-year Treasury bond has dropped over 0.5% from its high to 2.7% - lower than the dividend yield on many high-quality blue chip stocks. The drop in rates will support activity in the housing market as well as other sectors dependent on low borrowing costs.

There are other emerging economic trends that should serve to minimize the severity of the current slowdown. As noted, lower long-term interest rates will support sectors like housing and autos. The Fed has also strongly foreshadowed its intent to delay further hikes in short-term interest rates, which will reduce pressure on businesses and consumers carrying high levels of variable-rate credit card debt. A pause in interest-rate hikes could also help normalize (steepen) the yield curve, which would be a

welcome development for the beleaguered banking sector.

We also continue to get good news on the employment front. Not only are jobs being created at a robust pace, but wages are also rising at a better rate. Improved job prospects are beginning to draw people back into the labor force following a period during which the labor participation rate dropped from a high of over 67% to a low of 62.4% in 2015. Lastly, energy prices have plummeted, which will allow many consumers to divert those savings to other areas.

The “Put” Concept

All this is to say that for the first time in a while, there is a more equitable balance between the investment positives and

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negatives. Aside from the fundamental and technical factors discussed above, there are clearly some levers that government can pull which could have an important role in stabilizing the investment climate, restoring investor confidence, and perhaps shortening the duration of the market weakness. These policy adjustments might include a definitive trade agreement with China, a pause in the Fed rate-hike cycle, the passage of an infrastructure bill, and bipartisan agreement on immigration policy, to include political flashpoints like the border wall and DACA. As long as the potential remains to resolve these issues (or at least provide the illusion of resolution), we think the downside risk to stock prices could be somewhat contained. In other words, we think most would agree that a "policy put" exists.

In the financial world, a "put" is a financial contract that allows the owner of the put to sell an underlying security, like a stock, to the seller of the put at a predetermined price and future date. Investors who buy puts are seeking insurance against a big drop in the price of the underlying security. In the context above, we are simply saying

that stock investors may have become emboldened by the prospect that if stock prices fall enough, policymakers will step in to support stock prices by resolving one or more of the sources of volatility we describe above. Given the importance of the trade relationship with China, for example, we would expect to see big upward moves on days when progress is made in negotiations. Stock prices would also likely head higher on a definitive pause in interest-rate hikes by the Fed, the announcement of an infrastructure spending bill, or another round of tax cuts.

The increased volatility associated with these policy issues increases the importance staying invested. An analysis by Putnam investments determined that \$10,000 invested in the S&P 500 at the end of 2003 would have grown to \$30,711 by the end of 2018. However, if you had missed the market's twenty best days, you would still have only about \$10,000! Nobody can time the markets with any degree of precision and consistency over time. Don't try it!

One last thought on the "put" conversation.

Like no president in memory, President Trump appears to view the stock market as a barometer of his performance. As such, we suspect he will be highly likely to make major policy decisions based, at least in part, on their effect on stock prices. As we have seen with the Federal Reserve over much of the past 20+ years, this can be dangerous proposition. Investors emboldened by the prospect of being bailed out if things go wrong tend to accept more risk. On a macro scale, the increased investor risk tolerance can lead to asset bubbles. This concept is known as "moral hazard", and we wrote and spoke a lot about the dangers of moral hazard as it relates to Fed monetary policy over the past many years. We do believe, however, that there is a critical difference as it relates to the other policy risks. Because much of the risks are essentially self-inflicted, they are also eminently reversible.

Still, it remains unsettling that the tail (the markets) continues to wag the dog (monetary and fiscal policy) to a certain extent. Our belief is that over time markets are a reflection of the underlying economy. Thus, treating the markets (the symptom) instead of addressing underlying issues may exacerbate underlying problems. Nonetheless, our faith in the long-term prospects of the American economy and American business is undaunted. Our dogged research and commitment to great businesses with strong balance sheets still appear to be the best approach to weather the market vagaries ahead.

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